SUMMIT
ASSET MANAGEMENT

"It's Football Time in…?"

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If you are like us, you're likely dumbfounded. You sit back and reminisce over the events of the last six months and find yourself bewildered at what has happened. The economy has gone from roaring to a statistical depression. The stock market can only be described as a nauseating roller coaster ride. The behavior of our leaders, our neighbors, and ourselves in the face of a generational global pandemic can leave you perplexed. Now we find ourselves asking questions never before considered. Can I go back to the office? Will the kids ever go back to school? And probably, most importantly, will there be college football?

After a horrific first quarter, economies around the globe started to reopen. Equity markets responded with a furious comeback, one of the best in history. Alas, it was coming off one of the worst in history. With continued leadership from the technology sector, the U.S. once again led gains, rising 20%. Remarkably, this brings the S&P 500's year-to-date performance back to almost flat, down only -3%. Other markets, such as domestic small cap, developed international, and emerging markets also rose comparably during the quarter. However, they remain down -10% to -15% on the year. While gold is up this year, other commodity prices remain down -30%.

Bond markets also continued to firm up during the quarter. Both the Federal Reserve's promised and actual purchases in treasury, mortgage, and corporate bonds gave confidence to other market participants. The actions relieved much of the liquidity stress experienced during February and March and pushed bond prices higher. Other than treasuries and the safest corporate bonds, most bond markets have still posted negative returns on the year.

The Game

Most of us really are pining to see college football this year. If for no other reason, it will be a sign of a return to normalcy. Whether or not football makes it back to the field is yet to be determined, but there are some other real competitions being played in the economy and stock markets. The biggest battle is likely "COVID-19 vs. The Stimulus." In many ways, the stock market is our scoreboard.

COVID-19 is currently on offense, and the attack has been devastating. At a minimum, the unknowns about the virus have caused fear and anxiety. This has led to a health care crisis and unprecedented economic damage. As of this letter, the virus has resulted in over 3.4 million infections and almost 140,000 deaths in the U.S. The two-month long government mandated shutdown has caused 30 million Americans to file for (hopefully temporary) unemployment. Gross Domestic Product (GDP), a measure of economic activity, is estimated to drop by an annualized -35% during the second quarter before rebounding in the third.

Governments are on defense, all of them. Everyone, from the local school board to the President's Coronavirus Task Force, is in the game trying to stop the virus. In contrast with the 2008 Financial Crisis, the Federal Reserve and Congress have acted massively and decisively to shore up the economy and financial markets.

Congress has passed over $2.4 trillion in legislation to offset the impact of the recession. This has included taxpayer rebate checks, PPE loans, additional unemployment benefits, and direct aid to state and local governments. Since March, the Federal Reserve has enacted programs to purchase $2.9 trillion in various government and corporate bonds. Chairman Powell has also signaled that the Fed is prepared to do whatever it takes to keep the economy and markets afloat.

Looking at the scoreboard, recent stock market performance shows a close game. The momentum is definitely with the defense. The problem is we don't know how much time is left.

From an investing point of view, examining the score more closely is where things get interesting. Smaller skirmishes are being played out in the trenches. An important example is the "Work From Home vs. Reopening" trade. Groups of companies are benefiting and thriving as we work outside the physical office (Zoom or Netflix, anyone?) In many cases, these companies represent trends that were already in place, but are now being accelerated and pulling adoption forward. As these new habits likely become more permanent, these companies see their stock prices increase. In contrast, some more traditional companies would benefit more if things went back to the way they were before COVID. On a daily basis, the fortunes of these groups go up and down based on the number of new infections or which cities are adding or reducing restrictions.

We are also seeing a remarkable divergence in performance of sectors. Businesses that have been able to do well during the shut-down (technology, professional services, healthcare, consumer products, and essential services) have generally had buoyant stock performance. On the other hand, businesses that are more challenged to make a profit under normal circumstances (airlines, cruise lines, retailers, restaurants) have seen their stocks perform poorly.

Another often sighted clash is "Growth vs. Value." The energy sector is down -35% this year as oil prices suffer from overproduction and reduced demand. Financial stocks are down -25% as the decline in interest rates and reserves for expected defaults start to mount. Industrials remain down -15% as manufacturing has been slow to crank back up. These sectors are concentrated in the value part of the market and help explain the multi-year underperformance of value versus the more technology and health care weighted growth.

On the growth team, the S&P 500 has five companies – Microsoft, Apple, Amazon, Facebook, and Alphabet (Google) that represent 22% of the index. Year to date, these companies are up about 24% on average. This means that the other 495 companies in the index are still collectively down about -11% for the year. These companies have been on a spectacular run the past several years, and current conditions have only enhanced their prospects. They are phenomenal businesses that have come to dominate their segments of the economy. Because of their outsized gains and heavy weights in the indices, they have distorted market returns by masking the more mundane performance of the average stock.

Outlook

We must remember, there is no playbook for battling this virus. While still being played, a key determinant of us winning this game will be the success of reopening the economy. Our government, in all its efforts, looks to have handled the economic fallout from COVID-19 as well as could be expected. However, fighting the virus itself has been more challenging. Unlike other countries that acted more uniformly to shutter their economies and curb the spread of the virus, the U.S. denied, delayed and then delegated the problem to the states. This resulted in an uncoordinated 50-state solution. It appears some states were too slow to close businesses and too quick to reopen. Very few have been rigorous enough on social distancing and mask wearing. The result is that while Europe, Canada, and Northern Asia appear to have COVID-19 largely in check, we are seeing an alarming surge in new cases here. If unchecked, this surge could easily overwhelm the healthcare system, putting us back in recession, and making all the previous sacrifices moot.

At the beginning of this crisis, there was much debate on the kind of recovery the economy might experience. Most were rooting for a "V" shaped recovery. Everyone feared the "L". An acceptable recovery might resemble the Nike Swoosh. Today, as we become more familiar with the virus and how it is affecting day to day life, a "W" shaped recovery looks more probable. We will likely see fits and starts as we progress and adopt to the new world.

All of this leads to confusion among both investors and pundits about second quarter stock market performance. To quote a recent client email, "Nearly everywhere I look, there is chaos and uncertainty: political, employment, economic, health, etc. Yet, the markets don't seem to realize any of this and keep going up." Not discounting the fact that sometimes markets get temporarily carried away (on both the upside and downside), we think the examples given previously can help explain partially what is happening.

Global markets have rebounded in part on optimism surrounding the reopening of the global economy and hopes for a return to normalcy. Specifically, we are learning that a good portion of our economy and an even larger portion of our stock market can thrive in what might be the future. This future will likely be an altered version the past. New companies with new business models and new markets are giving investors new opportunities to take advantage. So, while about half of the companies out there are struggling in the new environment, the other half are finding ways to adapt and succeed. When looked at it this way, recent performance is a bit more rational.

Markets will always be forward looking. At some point, this crisis will end. When valuing potential investments, earnings today are a small fraction of a company's future worth. Far more emphasis is put on coming years where things will be better. There's also room for additional good news. An effective vaccine could arrive sooner than expected. The surge in new cases could reverse as more people practice social distancing and wear masks. Perhaps Congress will pass additional funding to support individuals and businesses.

While the current market has a lot of good news already priced in, we believe stocks still offer the most compelling prospects for investment, especially relative to government bonds which offer almost no return at all. However, as always, we expect volatility to continue as we head into the second half…of the year.

We thank you for your continued confidence and trust, and we welcome your comments, questions, and referrals. Please don't hesitate to contact us and stay safe and well. We will get through this together!

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